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Desperate for capital, small businesses turn to private lenders

Business owners turned down by banks are taking out 'hard money' loans, often at sky-high interest rates.

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With financial help for the nation's small businesses locked in a congressional imbroglio and bank loans still tough to get, many smaller firms are turning reluctantly to high-dollar lenders of last resort.

Across the nation, small businesses are paying private lenders annual rates of up to 36% plus fees to get the cash they need to buy inventory, pay their mortgages and meet payroll.

These private lenders say they're supporting small businesses at a time when credit is scarce, providing loans that help borrowers fix their credit scores or buy equipment to expand.

But the extra cash can come at great cost.

The struggle for credit has led business owners who had never ventured outside the highly regulated world of banks and credit cards to seek often expensive relationships with all kinds of other lenders. Among them, so-called hard money lenders take personal property or the business itself as collateral. Others function like payday lenders, offering cash advances against a business' anticipated revenue. There are also independent brokers, who put together applications for customers and seek loans from a variety of sources.

When a note came due on the trucking business that Thelma Standart owns with her husband in Wilmington, Calif., the couple needed more than $1 million dollars — right away. A bank loan fell through.

"We were forced to get a hard money loan," said Standart, who now pays $14,000 a month on a loan that would probably have cost less than half that at a bank. "It's bleeding our working capital."

What little credit that had been available to small businesses has dropped considerably this summer, as several measures aimed at helping small businesses got caught up in partisan fighting in Congress.

On the table in the Senate is a bill to restore funding to a key Small Business Administration loan-guarantee program and set up a $30-billion fund to encourage community banks to make small-business loans. Lawmakers are also debating new tax credits for small businesses that hire workers.

Senate Democrats have failed several times to break a Republican filibuster on the bill, most recently on Wednesday and Thursday. Negotiations will continue next week.

"We're just waiting," said Nick Seedorf, who hopes to hire 10 people with a loan backed by the Small Business Administration. His Los Alamitos companies, NuCourse Distribution and myGearStore, were approved for a loan guarantee just before the SBA program ran out of money in late May.

"Congress is playing politics with small business," said Roberto Barragan, president of the Valley Economic Development Center in Van Nuys.

President Obama has repeatedly called for banks to lend more to small businesses, and Ben S. Bernanke, chairman of the Federal Reserve, has also added his voice. But bank loans to small businesses remain scarce. And data from the Fed indicate that small businesses are paying more than other clients for any credit that they do get.

This expensive search for credit is a trend that alarms SBA chief Karen Mills. "This is of real concern to us," Mills said. "This credit crisis has really hit small businesses who have to rely on banks — and banks have pulled back."

Interest rates on private or hard-money loans can range from about 7%, or slightly more than at a bank, up to 36%, lenders interviewed for this story said.

Borrowers include all types of small businesses: a restaurant owner in Temecula, a Midwestern food processor who needs cash to buy fruit, a welding company fixing hurricane damage in Galveston, Texas.

Most say they contacted private lenders in desperation, usually after banks turned them down. They know they're paying more for the money but say they have no other options.

At Business Capital, a brokerage in San Francisco that specializes in private loans, inquiries from small businesses have doubled this year, said Erik Ostebo, director of credit and syndication. Many of them are referred by banks.

Charles "Chuck" Doyle, managing director of Business Capital, said his company functioned much like an investment bank for small and mid-size businesses, helping them develop plans to turn their companies around if they've hit rough times and connecting them with cash.

For some borrowers, he finds loans at about the cost of credit from a bank. But for those with checkered credit, the loans aren't cheap. "People get upset when they hear 9%," said Doyle. "Once they start hearing 12% or 13% they get really upset."

Private lenders have long been active in the world of small-business finance, offering high-cost loans to help businesses get started or funding entrepreneurs who have suffered reversals or bankruptcies.

But now their volume is way up, much of it from clients who would have been eligible for less costly forms of credit in the past.

The lenders say they look at a business' real potential when making a loan, analyzing its assets and cash flow in a way that banks do not. Loans are not made if the payments would put the business at risk, they insist.

"Some people do call us hard money lenders and loan sharks, and I take offense at that," said Don D'Ambrosio, whose company, Oxygen Funding Inc. in Lake Forest, advances cash against a company's billings. "We really do help a lot of businesses."

As bank loans dried up, private lenders experienced an onslaught of interest from small businesses, said Wallace Groves, executive director of the American Assn. of Private Lenders.

The for-profit organization used to be called the National Hard Money Assn. but changed its name in March. Many of its members lost money on subprime hard money loans in the real estate crash and are repositioning themselves to serve a wider variety of business clients, Groves said.

His organization is developing a code of ethics that calls for lenders to avoid predatory and unscrupulous practices. "We are working with a lot of these lenders helping them legitimize what private lending is," Groves said.

Terri Jennings turned to a form of private lending called "factoring" after three banks rejected her Texas welding businesses for loans. Every month, she hands over some of her invoices to Oxygen Funding, which advances her 80% of their value and holds on to the rest until her customers pay. It then deducts its fee — about 4% a month — and gives Jennings the rest.

The service is expensive, but it has kept her business afloat, she said. "It's either that or close the doors," Jennings said.

In the Riverside County city of Murrieta, broker John Reidy has been connecting people who don't qualify for bank loans with private money since 1978. Reidy recently arranged two such loans for The Bank Mexican Restaurant in Temecula, and another for a liquor store that needed help meeting expenses.

The restaurant was able to refinance the hard money with a loan backed by the SBA.

But Reidy said he might have to foreclose on the liquor store. "I hope not," he said. "But we may have to."

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Times staff writer Lisa Mascaro in Washington contributed to this report.